# 2. Transferable Development Rights: What They Are and How They Work

This paper suggests a program different from most traditional TDR programs. We believe this is the only way to create a successful incentive-based program that would fulfill the fundamental goals and objectives of the 2006 Growth Policy Implementation Program.

In order to see how our proposal is *not* a traditional TDR mechanism - and to offer insight into the reasons why this is so - we walk the reader step-wise through the basic components of a traditional TDR mechanism and what creates a successful development rights market.

## *2.1 TDR as a Market-Based Mechanism*

One of the more difficult challenges facing decision-makers in land-use planning is reconciling the inevitable differences between policy goals contained in land use plans and pre-existing patterns of land ownership and property rights. Landowners assert the right to build on or to sell legal parcels of land, whereas public policy may strive to designate that land for open space, agriculture, or a very low-density development.

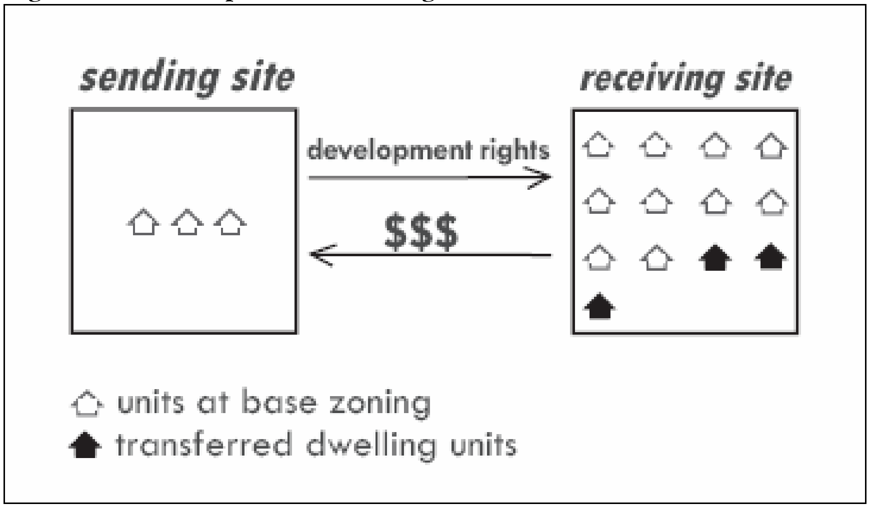
Nowhere is this more evident than in Gallatin County. The Commission's current Growth Policy Implementation Program calls for adopting county-wide density limits in the rural areas in a regulatory environment where no such designation currently exists.

Over time, many so-called "market-based" mechanisms have evolved to try to reconcile conflicting land use interests. These include creating "markets" for specific regulated commodities that the regulated parties may buy and sell, rather than requiring the regulated parties to act according to the explicit directives of command and control methods. Market-based models for land preservation directly address the conflict between developing land for revenue purposes, which might be a private landowner's priority, and preserving land, often a public policy objective.

In a standard TDR program, the right to develop land is severed from the land itself and treated as a separate right. Landowners in "sending areas" (areas designated for preservation) are permitted to sell their development rights to landowners or developers in designated "receiving" areas, who are permitted to build at higher densities if they purchase development rights. Once the development rights are sold from the property, the land is protected from future development in perpetuity with a conservation easement.

In the case of a TDR, Figure 2.1 illustrates a typical situation. A sending-site landowner is entitled to three development rights and obtains compensation for those rights by selling them to a receiving-site developer. The receiving-site developer is then permitted to build three more units above the baseline zoning in the receiving area. The voluntary nature of TDR programs allows private landowners to make decisions that are in their best interest, which can lead to economic efficiency advantages.

***Figure 2.1 Conceptual TDR Diagram***




TDR programs are best used to relocate development away from areas considered valuable by the community, such as farmland or important ecological land, toward areas with infrastructure and services to handle additional development. A TDR program is not well suited to reduce the total amount of development in an area. At the very least, it will permit the same amount of development but in a different configuration.

In some instances the policy may actually increase the overall number of dwelling units allowed if conditions warrant. For example, Figure 2.1 above illustrates a situation with little value disparity between sending and receiving areas. But this is often not the case, and in order to incentivize participation from the sending area landowner (i.e. create a mechanism that provides adequate compensation) additional transferable rights will need to be granted for each residential entitlement (see transfer ratio discussion below in Section 2.5.3).

## *2.2 Who Benefits and Who Bears the Cost?*

With any public policy, some individuals bear the costs of the policy and others capture the benefits. Effective TDR policy seeks to minimize the inequities between these two parties. The following discussion reflects TDR experience nationwide, not the specific proposal for Gallatin County.

Receiving-area landowners benefit from the increased density, which is capitalized into the value of their land. The increase in land value must be greater than the cost of the TDR required for additional development; otherwise the receiving-area landowners would have no motivation to acquire development rights. Sending-area landowners might experience a decrease in the value of their land due to subsequent loss of development potential, but are able to retrieve this loss by selling development rights. If the decrease in the value of the land is greater than the revenue received through the sale of the development right, sending-area landowners will have no motivation to sell.

Community residents benefit when they experience preserved open space with minimal expenditures of public money. That is, the community can achieve greater amounts of land preservation without the need to pass $10 million in open space bonds.

Receiving-area residents may experience a disproportionate share of the impact from increased density, including increased traffic and congestion. This can quickly result in residential "not in my backyard" (NIMBY) attitudes towards increased density. These local attitudes can be very powerful and can serve to derail a TDR program in its initial stages of development. Ultimately, the public benefit realized from the preservation of the sending parcels must outweigh the impacts incurred with developing the receiving area at higher density.

## 2.3 Key Components of Successful TDR Programs

TDR programs vary in the geography of their transfers and their regulatory framework, and therefore are implemented by a broad range of jurisdictions and through varying degrees of regulatory requirements. For example, some programs oversee small geographic areas with clearly identified receiving areas which require developers to purchase TDRs to build at any density level in the receiving area(s). On the other end of the spectrum, programs can be loosely structured with parcels in areas allowed to act either as sending or receiving sites.

The most effective programs balance the degree of regulatory requirements with the ability to create incentives for a healthy TDR market. If a program is too costly to administer or too costly for a developer to use, the program will certainly fail. From a government regulation perspective, a succinct and straightforward regulatory framework guided by a singular goal will reduce administration costs and has the greatest chance for success.

A TDR program should only be considered in a region possessing a strong demand for density with an active real estate market – that is, where land costs make it economically advantageous for a developer to "buy" increments of density rather than incur the costs of expensive land. In real estate markets where this is not the case, developers may be unwilling to buy development rights and the TDR program will struggle.

Furthermore, communities interested in implementing a TDR program must be willing to face the trade-offs of greater density in the receiving areas in exchange for greater preservation in the sending areas.

Research indicates the five components of utmost importance to a TDR program's success are:

1. Clear TDR Program Goals
2. Suitable receiving and sending sites
3. Adequate Incentives For Sending- and Receiving-Area Landowners
4. Inter-Jurisdictional Cooperation and TDR Service Area Size
5. Use of Banks and Other "Market-Making" Mechanisms

### *2.5.1 Clear TDR Program Goals*

A TDR program is not a policy in and of itself. Rather, it is an implementation tool used to implement a planning policy goal, usually community preservation of agricultural or open space land. This discussion on TDR goals – particularly in the context of the 2006 County Growth Policy Implementation Program - becomes especially important because it serves as the basis of our policy recommendations.

A TDR policy is flexible; it can be written with multiple goals in mind or possess a single focus. But, research shows that a more simple and focused TDR program is more likely to succeed. For example, traditional TDR programs that are most successful are structured around the preservation of definitive, and often small, geographic areas of properties that are valued by the community for their agricultural, ecological, or historical importance. Whatever the goals may be, it is important that they be clearly and succinctly defined.

### *2.5.2 Suitable Receiving and Sending Areas*

It is not usually difficult to identify sending areas; indeed, a TDR program often emerges from a strong political consensus to preserve a certain set of properties by removing development potential from them. Not all undeveloped lands represent suitable sending areas. Nor is it realistic to assume that all land can be preserved by transferring development rights elsewhere. The best sending areas are areas where the value of the development right closely matches the value received by the developer in the receiving areas from the increased zoning density.

On the other hand, it can be extremely difficult to identify politically-acceptable receiving areas because local resistance to increased density is so common. As we have said, a TDR program does not decrease the overall amount of development but, rather, represents a political consensus on a tradeoff. The ultimate question a community must ask itself when identifying the receiving and sending areas is: where does it wish to <u>discourage</u> development and where does it wish to <u>accommodate</u> development?

Obviously, the receiving-area land should be suitable for development and not unduly restricted by severe topography, wetlands and other sensitive features, or infrastructure service constraints. The receiving areas should be in areas of high market demand for development and include parcels near existing transportation, sewer, and water infrastructure. Proximity to infrastructure minimizes site development costs, making development more attractive to developers who wish to build with the use of TDR.

TDR programs tend to work better economically, and gain more political acceptance, when the sending and receiving areas are close to one another. As stated above, when development density is increased in an area at a great distance from the area being preserved, the residents near the receiving site bear an unequal share of the burden without any of the benefits. Research indicates TDR programs work most equitably when the external benefits are relatively local – that is, when sending and receiving sites are close to one another.[1] In these situations, the receiving-area residents recognize that they are sharing in the benefit of the land preservation in the sending areas.

### *2.5.3 Adequate Incentives for Sending and Receiving-Area Landowners*

Similar to the discussion regarding goals above, a description of incentives in a traditional TDR program versus the approach we are proposing in Gallatin County provide the reader the context for why we are proposing an alternative TDR idea.

Both sending and receiving-area landowners, in traditional TDR programs are given a voluntary alternative to the conventional development approval process. Therefore, both sets of landowners must view the TDR route as a more attractive alternative. For sending-area landowners, selling development rights must be equally profitable and more feasible than pursuing development of their property. For receiving-area landowners, building at higher densities must be more profitable and feasible than building at regular densities – and obtaining permission to build at higher densities by buying TDRs must be more attractive than seeking such permission by any other means. If both developers and landowners are not simultaneously motivated to participate in a TDR market, the program is unlikely to succeed.

Creating a successful TDR market requires three things:

1. Evaluating sending area supply and receiving area demand for TDRs.
2. Balancing TDR supply and demand by creating a viable "transfer ratio" between sending and receiving areas.
3. Maintaining strict control of the "currency" – that is, extra density in the receiving areas and surrounding vicinity.

### Supply and Demand in Receiving Areas

A TDR program creates a development right, or "TDR," as a marketable commodity that provides the owner of the TDR with a right to some increment of development in specified receiving areas

[1] Thorsnes et al, pg 262-263

(usually one housing unit). For a TDR program to work effectively, it must adequately address both the supply of development rights and the demand for TDRs in receiving areas.

One common mistake of TDR programs is to designate too little land as a receiving area, thus damaging the chances for a balanced market. If too many TDRs are chasing too few receiving sites, the price of TDRs will go down to the point where sending-area landowners have no motivation to sell. Receiving areas must contain more than enough parcels to accommodate the additional density that would be shifted into the area as the result of a successful TDR market.

To understand how to create a balanced market, it is important to conduct a market analysis that assesses the developers' demand for increased density in the receiving areas. The market analysis should ultimately quantify the value to the developer of purchasing an increased increment of development – that is, a TDR. This value we call the "Willingness to Pay" or WTP for increased density. This analysis should inform the size of the receiving area, subsequent appropriate density bonus, and how TDRs are allocated in sending areas.

## Transfer Ratios

A transfer ratio seeks to balance supply of development rights with demand for development rights. Transfer ratios are often used to equalize differing land values between sending and receiving sites; and also provide both sending-area landowners and receiving-area-developers sufficient incentive to participate in the program.

The ratio is simply the number of units a sending area landowner can build under current zoning entitlements relative to the number of TDRs allocated to the sending area landowner to sell. For example, if a sending-area landowner is able to build one house but is also given the option to sell one "TDR," this would be a 1:1 transfer ratio. Alternatively, a sending-area landowner may have the right to build one house, but be granted *two* TDRs to sell, this would be a 2:1 transfer ratio.

The transfer ratio should ultimately be determined by evaluating the market economics of sending area residents' development right values and receiving area developers' willingness to pay. An effective ratio should give the rural landowner enough TDRs to sell to capture the value of lost development potential at prices that would incentivize developers to buy the TDRs.

Thus, 1:1 transfer ratios work well where the values of sending and receiving areas are nearly equal. In some situations with large value disparities between the sending and receiving areas, transfer ratios can be as high as 30 to 1. This means that 30 units built in the receiving area for 1 development right retired in the sending area.

The current TDR proposal in Gallatin County is for 8 TDRs to be allocated for every 160 acres; and each TDR enables a receiving site developer to build 4 additional houses above the baseline. This equates to a 32:1 transfer ratio.

## Currency Control

Even the most sophisticated calibration of sending and receiving areas cannot make a TDR market work if the "currency" created by the TDR program does not retain its value. Receiving-area landowners will not participate in the market – that is, they will not buy development rights from sending-area landowners – unless a TDR purchase represents the most profitable and feasible way for them to obtain a density bonus.

This means the receiving-area jurisdiction must limit the supply of additional density that landowners can obtain by other means. Many jurisdictions undermine their own TDR programs by routinely permitting "up-zoning" through the normal regulatory process – in effect, giving the commodity away for free even though they are asking developers to pay for it in the TDR market. In other cases, the jurisdiction may provide density bonuses for other purposes – affordable housing, for example – which may send a signal to landowners that this competing goal is more important than the TDR program.

Either course of action can "devalue the currency" by providing receiving-area landowners with alternative ways to obtain a density bonus. These actions will greatly harm the chances of the TDR program's success.

### *2.5.4 Inter-jurisdictional Cooperation and TDR Service Area Size*

Inter-jurisdictional transfer agreements are the exception, not the norm, in other TDR programs, yet their presence is critical to regional growth management initiatives.

Nationwide, only a few programs include inter-jurisdictional agreements.[2] Different jurisdictions may have different goals, and the receiving jurisdiction may fear that it will bear a disproportionate "cost" or burden of the transferred development. Interlocal TDR agreements can work, but only when both jurisdictions can mutually benefit.

Transfers located within a single jurisdiction, and preferably within the same real estate market area, may face less opposition and may be politically and administratively easier to establish and maintain.

### *2.5.5 Using Banks and Other "Market-Making" Mechanisms*

TDR markets do not work seamlessly in all situations. When a policy attempts to use market forces to regulate, it is important for the individuals and firms engaged in the market to have adequate information. If market players are misinformed or unaware, they will not participate in the market in an effective manner. In addition, land markets frequently do not function in the same way as

[2] TDR programs with inter-jurisdictional agreements include King County, Washington; Boulder County, Colorado; and The Pinelands development credit program in New Jersey.

other markets. Often there are only a few market players, especially in undeveloped areas, and frequently those market players do not respond to normal economic signals. They purchase land for reasons unrelated to economic return; or they are longtime landowners with little debt and low taxes who are realizing a steady revenue stream and are not motivated by the prospect of a large economic return. In other words, even if a TDR market is well designed, it may not function well because the "right" buyers and sellers may not be in the marketplace at the "right" time.

A TDR bank seeks to facilitate transfers with purchases and sales of development rights. Assuming it is well capitalized – that is, staked with a significant amount of money - a TDR bank can buy, hold, sell, and even retire development rights in order to stimulate a slow market or bring balance to an uneven market.

The bank can also provide administrative assistance related to the transfer of development rights. While TDR banks are not required, their presence can serve as an important psychological support for landowners, developers, and government officials.

This is especially true for TDR programs just starting, where confidence in the program's long-term viability needs time to develop, and desirability of development rights in the receiving areas remains unproven. In this case a TDR bank can make 'up-front purchases' of development rights and help to ensure program success during initial stages.

TDR banks can exist at any level of government; state, county, municipal, or through non-profit organizations. A TDR bank's responsibilities can range from passive administrative roles to more active participation through careful timing of development right purchases and sales. For example, TDR banks can act to stimulate the market when market activity is low, and provide stability when the market is volatile. TDR banks can be funded through public bond referenda, dedicated taxes for open space purposes, or state and federal grants. Another potential role of TDR banks is funding through grants and low-interest loans, and the construction of receiving area infrastructure. This acts to reduce developer costs and stimulate greater demand to build in the receiving area.

Alternatively, the planning agency may use regularly scheduled auctions for development rights as a forum to bring willing buyers and willing sellers together.[3] This serves several beneficial purposes. Auctions can directly establish the market price for TDRs and quickly inform market players as to probable supply and demand. Auctions can expedite sales and increase overall market activity. If these auctions are held on a yearly or bi-yearly interval, market players will be well informed and the overseeing agency will have updated information to assess the TDR program's effectiveness. Auctions also serve as a forum to educate the public about the local TDR program. These auctions have been known to not only stimulate and educate local landowners about the use of TDR but also attract developers from a larger geographical area.

[3] Chesterfield Township in New Jersey, one of the more active and successful TDR programs in the Country, holds annual development right auctions.